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No. 89-1832

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

HEALTHCARE INTERNATIONAL, INC., WEST OAKS, INC., HEALTHCARE-BROWN MANAGEMENT CO., THE BROWN SCHOOLS, INC., JAMES L. FARISS, JR., DAVID L. WHELAN, AND ELLIOTT H. WEIR, JR.,
Petitioners,

v.

L & B HOSPITAL VENTURES, INC., LEO J. BORRELL, BOBBY R. LOWRANCE, PSYCHIATRIC ASSOCIATES OF HOUSTON, P.A., AND DOUGLAS B. HANSEN,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITIONERS' REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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To the Honorable Chief Justice and the Associate Justices of the Supreme Court of the United States of America:

Petitioners Healthcare International, Inc. ("Healthcare"), West Oaks, Inc., Healthcare-Brown Management Co., The Brown Schools, Inc., James L. Fariss, Jr., David L. Whelan, and Elliott H. Weir, Jr., submit this Reply Brief in Support of Petition for Writ of Certiorari:

I. Factual Counter-Statement

In their Brief in Opposition to Healthcare's Petition for Writ of Certiorari, the Respondents have once again shifted their position, denying before this Court factual admissions that they made in the District Court. Federal appeals courts generally should not consider arguments presented for the first time on appeal. *California v. Taylor*, 353 U.S. 553, 556 n.2 (1957).

In this case, the Doctors admitted both in their briefs and to the trial court in oral argument that they made significant contributions to West Oaks' profitability and success. For example, in their brief to the trial court, Plaintiffs admitted contributing 40-60% of the hospital's revenues. R. 471. It was only after the trial court's adverse ruling that they "reinterpreted" the data to suggest to the Court of Appeals that the contributions were not significant.[1]

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[1] The statistics cited in Respondents' Response do not support their conclusions. Respondents have taken a deposition exhibit out of context to suggest that their contributions to revenues were insignificant. Those statistics were part of a report on the Doctors' contributions to West Oaks. The Doctors attached the entire report to their Response to the Motion for Summary Judgment. As the Doctors admitted in their brief in the trial court, "[T]he limited partners accounted for the following percentages of admissions: 1982: 51%; 1983: 41%; 1984: 56%; and 1985: 41%." R. 471. Undoubtedly, this contribution is "significant" by any reasonable definition of that term.

The Doctors also argue in their brief that their access to information regarding the partnership was limited. Brief in Opposition at 11, 26. The Doctors testified in their depositions that under the contracts they had complete access to information regarding the venture. Healthcare International, Inc., et.al.'s Response to Motions for Summary Judgment at 25-26, 37, 44-46.[2] Dr. Hansen testified that he was "inundated" with information regarding the hospital. *Id.* at 45 (citing Deposition of Hansen at 135, 141-45, 164, 184-86, 187-91).

II. Respondents Have Admitted the Conflict Between the Court of Appeals' Opinion and the Prior Decisions of This Court

A. The Court of Appeals' "Gloss" Conflicts with the *Howey* Test

The purpose of the third prong of *Howey* was to exclude from the ambit of securities laws those investors who have, either formally or informally, significant influence over the operation and success of their investment. *Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983). Respondents have conceded that the Court of Appeals applied a "gloss" on the *Howey* test. Brief in Opposition at 14, 15. Petitioners respectfully suggest that the "managerial efforts" limitation fundamentally altered the nature of the *Howey* test. *See Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 (4th Cir. 1988); *Meyer v. Dans un Jardin,*

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[2] The Response of Healthcare to the Doctors' Motions for Summary Judgment was inadvertently omitted from the record sent to the Court of Appeals. Consequently, the Response was not numbered and cannot be cited to the record. It was part of the record before the trial court at the time the court rendered its decision, however. References to the Response shall be cited as "Response at ....."

S.A., 816 F.2d 533 (10th Cir. 1987); *Inforex Corp. v. MGM/UA Entertainment Co.*, 608 F. Supp. 129 (C.D. Cal. 1984).

In applying *Howey*, courts have recognized that where an investor's efforts are menial or ministerial, the investor may nevertheless claim his or her interest is an investment contract, because the investor's efforts have no practical effect upon realization of the anticipated profits. As the SEC has noted:

> [W]here the duties assigned [to the investor] are so narrowly circumscribed as to involve little real choice of action or where the duties assigned would in any event have little direct effect upon the receipt by the participant of the benefits promised by the promoters, a security may be found to exist.

Securities Act Release No. 5211, [1971-1972 Transfer Binder], Fed. Sec. L. Rep. ¶ 98,446 (CCH November 30, 1971); *e.g., SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). The Doctors have not adduced any evidence that they had no real choice of action, and have admitted that their duties were critical to the profitability of their investment.

In this case the Doctors' efforts were indisputably far more than menial or ministerial. The Doctors testified at length regarding the numerous contributions they made to the hospital and the importance of their participation to the success of the enterprise. *See* Petition for Writ of Certiorari at 5-10. The Court of Appeals brushed those admissions aside, holding that unless those undeniably significant contributions were "managerial," they simply could not be considered in applying the *Howey* test. App. at A5. Petitioners believe that this Court never intended an investor with such a deep involvement in the operations and profitability of his investment to come within the ambit of *Howey*.

B. There Is No Presumption That Limited Partnership Interests Are Securities

Respondents predicate virtually all of their factual statement and much of their Response on the notion that because their interests were formally denominated "limited partnership" interests, they are entitled to invoke the protection of the securities laws. Brief in Opposition at 2-8, 16-19, 26-27. Specifically, Respondents argue that there exists a "presumption" that their interests are securities under the *Howey* test. *Id.* at 16-19.

Respondents' argument is based upon a lone Seventh Circuit opinion holding that limited partnership interests are inherently securities as a matter of law. Brief in Opposition at 18 (citing *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979)). The Seventh Circuit's opinion in *Goodman* directly conflicts with this Court's requirement that in applying *Howey*, federal courts are to be guided by the economic realities of the parties' relationship rather than by mechanistic reliance on labels. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *Matek v. Murat*, 862 F.2d 720, 727 (9th Cir. 1988). *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). The conflict between the holdings in *Goodman* and *Matek* simply underscores the need for this Court to grant the petition and reaffirm *Howey's* fundamental requirement that an investor must expect profits to be derived from the efforts of *others* in order to assert his interest in an "investment contract."

The Court has addressed the issue of when a presumption exists that an investment is a security. In *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), the Court held that only corporate stock was entitled to a presumption of the kind suggested by Respondents. *Id.* at 687-697; *see Reves v. Ernst & Young*, 58 U.S.L.W. 4208 (1990) (holding that notes are not entitled to presumption under Landreth). If instruments expressly listed in the statutes as securities are not "presumed" to be covered by the

act, investments such as the Doctors' limited partnership interests cannot benefit from such a presumption.

In this case, the limited partnership interests at issue were not publicly traded. There were only four limited partners. The agreements reflected the kind of unique one-on-one negotiations that take such interests outside the securities laws. The "economic realities" of the situation overwhelmingly established the substantial control the partner/doctors possessed. In addition to their formal powers under numerous collateral contracts, the Doctors possessed the enormous degree of influence and control possessed by any rainmaker partner in a closely held enterprise. The control and influence exercised in such a situation far exceeds the level of "menial" or "nominal" participation contemplated by *Howey* and later cases.

C. The Doctors, as Promoters of the Venture, Cannot Assert That Their Interests Are Securities

It is both implicit and explicit in *Howey* and its progeny that a promoter is precluded from asserting that his or her interest is a security. In *Howey*, by defining an investment contract as a scheme "whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party," 328 U.S. at 299, the Supreme Court implied that, for the purposes of federal securities statutes, an investor and a promoter are distinct, and that only the former interest constitutes an investment contract.

Cases interpreting the *Howey* decision have made it evident that a "promoter" is to be defined as that party which sought the investment of money by others. Thus, in defining a "common enterprise" under *Howey*, courts frequently refer to schemes wherein the investors' fortunes are dependent on "the efforts and success of those seeking the investment or of third parties," in essence substituting "those seeking the investment" for "promot-

ers" in the language of the *Howey* test. *See, e.g., Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 223 (6th Cir. 1980); *S.E.C. v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). It follows that the "promoter," being the party who induced the investment of another, does not have a "security" as contemplated by the *Howey* test.

In this case, contrary to the Doctors' allegations, the Doctors were in fact the "promoters" of this venture and are precluded from claiming that their interests are securities. It was the Doctors who proposed their scheme to Healthcare and successfully sought "the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299. The Securities and Exchange Commission, in Rule 405 under the Securities Act of 1933, has defined "promoter" to include:

> (1) Any person who, acting alone or in conjunction with one or more persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer.

17 C.F.R. 230.405(q). Federal courts have often turned to this common-sense definition to determine if a party is a "promoter" for the purposes of the securities laws. *See, e.g., Townshend v. United States*, 384 F.2d 1008, 1012 (Ct. Cl. 1967); *Ingenito v. Bermec Corp.*, 441 F. Supp. 525, 537 (S.D.N.Y. 1977).

In this case the Doctors exercised the "initiative" in founding and organizing the venture. They undertook efforts to develop a hospital to be owned by them to which they would admit their patients, R. 716-717, 787-788, and for which they would create and implement programs. R. 687-88, 723-26, 779, 831-33. They hired a business consultant and attorneys, filed a certificate of need application for the project, and invested approximately $120,000 in promotional expenses, R. 688, 723-26, 741-76, 784, 813, 832-33, all before they even approached Healthcare in mid-

1979. Furthermore, Healthcare was only one of several companies approached by the Doctors. The agreement ultimately reached created a limited partnership in which Healthcare was to provide administrative services and arrange financing for the hospital. R. 689,779-81, 836, 929-30. Based on these facts, it is evident that the Doctors where the "promoters" of this venture.

III. Respondents Have Ignored the Conflict Between the Circuits Created by the Court of Appeals' Decision

A. The Court of Appeals' Test Has Previously Been Rejected by Other Federal Courts

Contrary to Respondents' assertions, other federal courts have expressly rejected the "managerial efforts" test adopted by the Court of Appeals. A review of the cases cited in the Petition for Writ of Certiorari supports Petitioners' argument.

In *Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989), the court expressly rejected the "managerial efforts" limitation. In its review of the parties' position, the Tenth Circuit noted that the plaintiff's "approach to the case focuses mainly on the distribution and exercise of *managerial responsibility* for this project." *Id.* at 1457 (emphasis added). The Tenth Circuit rejected this approach: "[T]he language from *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533, 535 (10th Cir. 1987), upon which Maritan relies is a general, not exclusive, statement." *Id.*

Similarly, in *Inforex Corp. v. MGM/UA Entertainment Co.*, 608 F. Supp. 129 (C.D. Cal. 1984), the court found that the characterization of the efforts as something other than "managerial" did not alter the *Howey* analysis. Respondents ignore the plain language of the *Maritan* and *Inforex* opinions in their

attempt to avoid the clear conflict created by the Court of Appeals' opinion in this case.[3]

B. The Test Applied by the Court of Appeals Conflicts with the Test Applied by Other Federal Courts

In addition to conflicting with every other opinion to directly address the point, the Court of Appeals' opinion implicitly conflicts with the test adopted by other federal courts in applying *Howey*.

In applying *Howey* to partnerships, federal courts generally have been confronted with three distinct factual situations. In many cases, the plaintiff has purchased a general partnership or other interest in an enterprise and retains in the documents formal powers of management and control sufficient to permit him or her to protect his or her interests. In these cases, courts generally have recognized that the failure of plaintiff to exercise those powers does not alter the fact that those powers exist. *E.g., Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

Many of the cases Respondents rely upon fall within this category. For example, in *Youmans v. Simon*, 791 F.2d 34 (5th Cir. 1986) (cited at Brief in Opposition at 18) the court held that analysis of the formal documents determined the issue. In *Youmans*, however, the court noted that because plaintiffs were general partners, they had sufficient input into the venture to preclude a finding of a security as a matter of law. 791 at 346. Similarly, in *Williamson*, the Fifth Circuit held that absent

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[3] Similarly, as noted above, there is a conflict between the circuits regarding whether or not an interest denominated a "limited partnership" is inherently a "security" or whether, as Healthcare contends, the courts must apply the *Howey* test to such interests to make sure they fit within the definition of an "investment contract" as that term is used in federal securities laws.

unusual circumstances the formal powers granted a general partner prevent a finding that such an interest is an investment contract. 645 F.2d at 422. In *Kline Hotel Partners v. Aircoa Equity Interests, Inc.*, 725 F. Supp. 479 (D. Colo. 1989), the plaintiffs were general partners. The court found an issue of fact regarding whether unique circumstances precluded them from exercising their management powers. *Id.* at 482. Had the court in *Kline* followed Respondents' urging and looked only at the formal partnership documents, plaintiffs' securities claims would have been precluded as a matter of law. *Id.* at 481-82. Respondents have cited no case in which an investor who in fact had substantial authority over the affairs of the enterprise or who possessed the ability to affect the success and profitability of the venture was found to possess a security based solely on the formal recitations contained in one of the parties' agreements.

A second group of cases are those in which the formal documents between the parties purport to deny authority to the plaintiff, but the plaintiff in reality has significant power and control over the affairs of the enterprise. *E.g., Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982), *cert denied*, 459 U.S. 1203 (1983); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981). In such a case, the courts consistently find that no security exists.

Finally, there are cases where both the formal documents and the economic realities deny the plaintiff any significant power to control the operation of the enterprise or to affect its profitability. *E.g., SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). In these cases, and only in these cases, do the courts find a security, because only in these cases may it be said in any meaningful sense that the investor expected his profits to be derived solely from the efforts of the promoter at

the time he made his investment. *Rivanna Trawlers Unlimited*, 840 F.2d at 241.

By accepting the Respondents' "managerial efforts" distinction, the Court of Appeals has created an entirely new class of cases, wherein the elements traditionally applied to determine whether an interest is an investment contract are ignored and the label the parties put on their efforts controls.

IV. Conclusion

It is undisputed that Respondents possessed powers of control and influence — both formally by virtue of contractual agreements and informally by virtue of their power to affect profoundly the profitability of the enterprise — that prohibit a finding that their interests were a security. The Fifth Circuit expanded the ambit of federal security laws to situations where they have never heretofore been found to apply. This Court should remove the "gloss" on *Howey* adopted by the Court of Appeals in this case.

Respectfully submitted,

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